

Internal Revenue Service
memorandum

CC:TL-N-9976-87
Br1:JDMacEachen

date: 001 20 1987

to: District Counsel, Manhattan CC:MAN

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for technical advice dated August 12, 1987.

ISSUE

Whether tax benefits resulting from the investment tax credit may be taken into consideration in determining the profitability of a transaction, for purposes of determining whether a given transaction constitutes an economic sham.
0048.01-00; 0162.01-08; 0167.01-00; 0212.15-00.

CONCLUSION

In the absence of a primary profit motive, property will not be either "used in a trade or business" or "held for the production of income", and thus ineligible for depreciation or the investment tax credit. Thus, the investment tax credit, like the tax benefits arising from other deductions, credits, allowances, and tax attributes arising from a transaction, is not to be considered when determining whether there exists an expectation of an economic profit from a transaction.

FACTS

Petitioner [REDACTED], a corporation, is a limited partner in [REDACTED] a computer leasing limited partnership. [REDACTED] purchased certain computer equipment from a computer leasing company, [REDACTED], subject to a pre-existing lease to an end-user. [REDACTED], in turn, leased the equipment back to [REDACTED] for an amount roughly equal to its acquisition costs. [REDACTED] now seeks to be treated as the owner of the equipment for tax purposes.

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The out of pocket cost of a single [REDACTED] partnership unit was \$[REDACTED]. The [REDACTED] offering memorandum contained an appraisal indicating that the equipment would have a value in [REDACTED] of roughly 20% of its then fair market value. We note that the equipment would not vest in [REDACTED] until [REDACTED], at which time its value would be substantially less than 20%. The memorandum also contained two projections of cash flow, based on residual values for the equipment in [REDACTED] of 10% and 20% of the equipment's [REDACTED] fair market value. Assuming a 10% residual value for the equipment, total income net of tax benefits was projected to be \$[REDACTED] per unit, producing an economic loss of \$[REDACTED] per unit. Assuming a 20% residual, total income net of tax benefits was projected to be \$[REDACTED], producing an economic loss of \$[REDACTED] per unit.

Petitioner argues that it may include in the computation of economic benefits an investment tax credit of \$[REDACTED] per unit, producing a profit of \$[REDACTED] and \$[REDACTED], based upon a 10% and 20% residual respectively. Petitioner reasons that the investment tax credit should be considered an economic benefit rather than a tax benefit for purposes of determining whether a transaction has economic substance. Thus, the question presented is whether the investment tax credit may be taken into consideration in determining whether a transaction has economic substance.

Preliminary Discussion

Generally, a transaction will be ignored for federal tax purposes if it is found to be devoid of economic substance and business purpose i.e., if it is found to constitute an economic sham. The economic substance test requires an objective determination of whether a reasonable possibility of profit exists apart from tax benefits. The business purpose test involves an inquiry into the motives of the taxpayer in entering the transaction, and may be met either by the business purpose of the taxpayer, or that of another party to the transaction. See, generally, LEM 7059.1 CHG 122 Equipment Leasing Litigation (May 19, 1987). We shall confine our comments to the application of the economic substance test.

ANALYSIS

In Gefen v. Commissioner, 87 T.C. 1471 (1986), the Tax Court stated the general rule that a transaction has economic substance and will be recognized for federal income tax purposes if the transaction offers a reasonable opportunity for economic profit, independent of tax benefits.

The fact that a transaction generates tax benefits for investors does not necessarily mean that the transaction lacks economic substance. Frank Lyon Co. v. United States, 435 U.S. 561, 581 (1978); Mukerji v. Commissioner, 87 T.C. 926, 958 (1986); Estate of Thomas v. Commissioner, 84 T.C. 412, 432 (1985). However, where a transaction is entered into without any purpose other than to obtain tax benefits, the form of the transaction will be disregarded and the tax benefits will be denied. Law v. Commissioner, 86 T.C. 1065, 1093 (1986); Estate of Thomas v. Commissioner, *supra* at 432-433. A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits. Estate of Thomas v. Commissioner, *supra* at 438; Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 203 n.17 (1983), *affd. on this issue*, 752 F.2d 89 (4th Cir. 1985).

Gefen, *supra* at 1490.

Gefen did not involve an investment tax credit issue, but the same definition of economic substance applies in cases involving the investment credit.*/ Beck v. Commissioner, 85 T.C. 557 (1985); Grace v. Commissioner, T.C.M. 1986-304; Seely v. Commissioner, T.C.M. 1986-216.

The genesis of the economic substance rule is found in the "trade or business/held for the production of income" language of the Code.

Revenue Procedure 75-21, 1975-1 C.B. 715, sets forth guidelines to be used by the Service for advance ruling purposes to determine whether a leveraged lease will be respected for federal tax purposes. Condition #6, found at section 4(6) provides:

"The lessor must represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances,

*/ We note that the concept of economic profit, exclusive of tax benefits, also arises in the context of determining whether a transaction was entered primarily for profit, within the meaning of IRC § 183. A disparity between pre-tax profits and projected tax benefits is a factor to be considered in determining whether an activity is engaged in for profit. See Estate of Baron v. Commissioner, 83 T.C. 542, 557-558 (1984) *aff'd*, 798 F.2d 65 (2nd Cir. 1986).

credits, and other tax attributes arising from such transaction."

The rationale for this requirement is discussed in Lease v. Sales, G.C.M. 37184, I-4359 (June 30, 1977), at 10.

The final guideline requires an expectation of an economic profit from the transaction apart from the tax benefits arising from the transaction. This requirement is important for depreciation and investment credit purposes. Code § 167(a) allows a deduction for depreciation only with respect to property "used in the trade or business" or "held for the production of income." This requirement has been construed to mean there must be an intent to conduct the trade or business or hold the property for profit. E.g., International Trading Co. v. Commissioner, 275 F.2d 578 (7th Cir. 1960) (depreciation denied corporation for a summer residence; enterprise must be initiated or conducted with an intention of making a profit or of producing income). Code § 48(a) limits the investment credit to property with respect to which depreciation is allowable and therefore both depreciation and investment credit depend on a profit motive.

A similar analysis is found in [REDACTED] G.C.M. 36822, I 254-75 (August 20, 1976). A railway planned to purchase certain equipment, which it proposed to lease to an unrelated corporation. The corporation would then sublease the equipment to the parent of the railway. Both leases would have the same term and the same rent, and both would be net leases. However, the lease to the unrelated corporation would call for an additional semi-annual payment in exchange for the lessor railway's election to pass the investment tax credit through to the corporation. Neither the parent of the railway, nor the railway could fully utilize the investment credit generated by the purchase of the equipment.

The lessee corporation would pay more rent under the initial lease than it would receive under the sublease. Further, the corporation had no interest in the residual. As the corporation had no opportunity for a profit, it was held to lack the profit motive required by the investment tax credit provisions. Thus, the G.C.M. concluded that the investment tax credit could not be passed through to the corporation.

As noted above, the revenue procedure and the two G.C.M.'s base the requirement of economic profit on the "trade or business/held for the production of income" language of the Code. During the years at issue in this case, section 38 of the Code allowed a credit against federal income tax for investments

in section 38 property. Section 38 property was defined in section 48(a)(1) to include only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable. Section 167(a) allows a depreciation deduction only for property used in a trade or business or held for the production of income. Accordingly, the investment tax credit is available only to a taxpayer who is engaged in a trade or business or is holding the property for the production of income. Beck v. Commissioner, supra; Flowers v. Commissioner, 80 T.C. 914 (1983); Pike v. Commissioner, 78 T.C. 822 (1982), affd. without published opinion, 732 F.2d 164 (9th Cir. 1984).

The phrases "trade or business" and "held for production of income" are used in numerous places throughout the Code. See for example, sections 162, 165(c), 167, 183, 212, and 1231(b) of the Code. Numerous court decisions have interpreted the phrases "trade or business" and "held for production of income" in the context of determining whether property is subject to the allowance for depreciation. These cases uniformly hold that a taxpayer must have a profit motive to be engaged in a trade or business or to hold property for the production of income. Brannen v. Commissioner, 78 T.C. 471 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984); Beck v. Commissioner, supra; Flowers v. Commissioner, supra; Pike v. Commissioner, supra; International Trading Company v. Commissioner, supra; Fackler v. Commissioner, 45 B.T.A. 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); Yanow v. Commissioner, 44 T.C. 444 (1965), aff'd, 358 F.2d 743 (3d Cir. 1966). See also: Helvering v. National Grocery Company, 304 U.S. 282 (1938) and Hock v. Commissioner, T.C.M. 1987-444. "We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." Commissioner v. Groetzinger, 480 U.S. ___, 107 S. Ct. 980, 987 (1987). Thus, when Congress chose to define section 38 property by reference to property subject to depreciation, it was referring to a statutory concept with a well established meaning in so far as the requirement of profit motive is concerned.

When Congress borrows an already judicially interpreted phrase from an old statute and uses it in a new statute, it is presumed that Congress intended to adopt not merely the old phrase but also the judicial construction of that phrase. Long v. Director, Workers' Compensation Programs, 767 F.2d 1578 (9th Cir. 1985); Fusco v. Perini North River Associates, 601 F.2d 659 (2nd Cir. 1979), vacated on other grounds, 444 U.S. 1028 (1980). See also, Burnet v. Harmel, 287 U.S. 103 (1932). In the absence of explicit language indicating a different purpose, Congress should not be held to have intended a meaning that is

at odds with the established meaning in the prior statute.

Nothing in the statutory language of section 48(a) of the Code or its legislative history explicitly or implicitly suggests that Congress had a special meaning in mind for section 38 property that differed from the established meaning of property subject to depreciation. It would have been a simple task for Congress to have stated that the investment tax credit would be treated as profit for purposes of determining whether the taxpayer was engaged in a trade or business or holding the property for the production of income. Congress did not do so.

Nor did Congress suggest a different meaning in the legislative history. The senate report accompanying the Revenue Act of 1962, which enacted the investment tax credit provisions, states that the investment tax credit would stimulate investment

by reducing the net cost of acquiring depreciable assets, which in turn increases the rate of return after taxes, ... [by] increasing the flow of cash available for investment ... [and by] a reduction in the "payoff" period for investment in a particular asset. This reduction in risk, coupled with the higher rate of profitability and increased cash flow will lower the level at which decisions to invest are made"

S. Rep. No. 1881, 87th Cong., 2nd Sess. 11 (1962)

As the quoted language shows, Congress intended the investment tax credit to stimulate investment in capital assets by increasing the economic profit from such an investment. There is no indication that Congress sought to create an artificial profit based on tax credits where no economic profit would otherwise exist. More to the point, there is absolutely no indication Congress intended the phrase "property with respect to which depreciation is allowable" to mean anything other than what it had been interpreted to mean under section 167 of the Code.

Contrast the legislative history of the investment tax credit provisions with the legislative history of section 236 of the National Housing Act (the Act) discussed in Rev. Rul. 79-300, 1979-2 C.B. 112. Section 236 of the Act provides a mortgage subsidy to partnerships which construct low-income housing projects. In exchange, the partnership must operate the project subject to the Department of Housing and Urban Development's rental restrictions. As a result, the partnerships are not expected to earn a profit. Rev. Rul. 79-300 nevertheless concluded that section 183 of the Code, (which precludes deductions of losses from activities not engaged in for profit), did not apply to such a partnership

activity. In reaching that conclusion, Rev. Rul. 79-300 pointed to the legislative history of section 236 of the Act which states:

The partnership arrangement makes it possible to assure an adequate return to investors. Under existing Internal Revenue Service regulations and rulings, partnership losses for tax purposes flow to the individual partners The annual accelerated depreciation of the building cost results in substantial book losses during the initial ten years after the project is built. Assuming the member of the partnership is in [sic] relatively high income tax bracket, his share of the depreciation losses, plus cash income from project operations would provide an after-tax return on his investment which would compare favorably with the return which most industrial firms realize on their equity capital.


S. Rep. No. 1123, 90th Cong., 2nd Sess. 85 (1968).

Unlike the legislative history of the investment tax credit provisions, which indicates an intent to increase the profitability of an investment in depreciable property, the legislative history quoted above makes clear that Congress sought to offset an investor's losses with tax benefits sufficient to create a return comparable to that earned by profit motivated companies.

In summary, we believe that the statutory language used by Congress in providing for the investment tax credit makes clear that the credit is available only in transactions in which the taxpayer has a profit motive independent of tax benefits, including the investment tax credit. Congress intended the definition of depreciable property found in section 48 of the Code to be interpreted in the same manner as it had been interpreted under section 167. Nothing in the statutory language or the legislative history in any way suggests that Congress intended any other interpretation. Therefore, in determining whether a given transaction constitutes an economic sham, profit must be interpreted to mean economic profit independent of tax benefits, including the investment tax credit.

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Attachments: (2)
G.C.M. 36822
G.C.M. 37184